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NEWS AND INFORMATION FROM BENESCH'S BUSINESS REORGANIZATION PRACTICE GROUP

Basics of Distressed Debt Investing: Claims Trading Strategy

Holders of bankruptcy claims have routinely been willing to sell their claims at a substantial discount in exchange for a prompt and certain cash payment rather than facing the uncertainties of the bankruptcy process and the possibility of a payment in the distant future. Claim purchasers must be wary of the consequences of acting on "insider" information and acting without good faith. Additionally, claim traders must be aware of whether an order has been entered in the bankruptcy proceeding restricting the trading of claims and securities of the debtor. This is the first of a two-part series that is intended to (1) give a brief overview of claim trading by examining claim trading strategy and claims trading restrictions, and (2) discuss the effects restrictions will likely have on distressed debt investors (e.g., hedge funds).

Generally speaking, purchasers of claims, or distressed debt investors, may be classified as either passive or active investors. Passive distressed debt investment needs little discussion as it is based on straightforward, rational economics. A rational distressed debt investor may be motivated to purchase the claims against a debtor if, and only if, he or she believes, after taking into account the time value of money, that the distribution expected to be paid on the purchased claim will be greater than the purchase price of such claim. Assuming (i) the transfer of the claim is absolute, (ii) the requirements of Fed. R. Bankr. P. 3001(e) have been satisfied and (iii) no other motivational factors are involved, this type of investor will likely be an inactive player in a bankruptcy case.

Claim purchasers must be wary of the consequences of acting on "insider" information and acting without good faith.

An active distressed debt investor is an investor who is seeking to "actively" participate in the debtor's bankruptcy proceedings by, for example, forcing a sale of the debtor's assets or affecting plan voting. In order for an active distressed debt investor to accomplish his or her goals, he or she must have standing (i.e., be a party-in-interest) in the debtor's bankruptcy proceedings.

As is common in many bankruptcy cases, a person who does not have a direct financial stake in a debtor's bankruptcy proceedings may wish to purchase some or all of the debtor's assets. If this type of potential purchaser is unable to purchase the target-debtor's assets with the target-debtor's consent, he or she may wish to side-step the target-debtor by proposing a plan of reorganization that provides for him or her to purchase some or all of the target-debtor's assets. The problem facing this type of potential purchaser is that since he or she is not a "party-in-interest," he or she is precluded from proffering a plan of reorganization. How can the potential purchaser get around this conundrum? By purchasing a claim of virtually any size of the target-debtor. Once the potential purchaser purchases a claim of the target-debtor, he or she becomes a party-in-interest in the target-debtor's bankruptcy proceedings. Once a potential purchaser becomes a party-in-interest,

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and upon the expiration of the exclusivity period, he or she has standing to proffer a plan of reorganization that provides for the sale of the target-debtor's assets.

Another type of active distressed debt investor is one who purchases a large number of claims to gain leverage to bargain the plan terms with the debtor or who seeks to file a competing plan of reorganization. This type of investor is usually seeking to affect the size and/or timing of distributions set forth in a plan of reorganization.

The distressed debt investor is cautioned to consult with experienced bankruptcy counsel prior to developing and effectuating a claim trading strategy.

Other active distressed debt investors may purchase claims in order to affect plan voting to advance a personal agenda. To the extent this type of active investor is able to affect plan voting, he or she may be able to gain substantial leverage over the plan proponents or even other creditors; however, this investor must be careful that he or she does not act in bad faith, which could then designate (i.e., disqualify) a vote of that investor.

This, of course, begs the question of what is "good faith" with respect to plan voting. Since Congress chose not to include the definition of "good faith" in the Bankruptcy Code, its definition has been developed by case law, and thus, is nebulous. One Court stated that:

> Good faith voting does not require nor can it expect, a creditor to act with selfless disinterest…. The test then, consonant with the United States Supreme Court's standard, is whether a creditor has cast his vote with an "ulterior purpose" aimed at gaining some advantage to which he would not otherwise be entitled in his position….

Ulterior or coercive motives that have been held to constitute bad faith include pure malice, strikes, blackmail, and the purpose to destroy an enterprise in order to advance the interest of a competing business.

In re Gilbert, 104 B.R. 206 (Bankr. W.D. Mo. 1989) (internal citations and quotations omitted).

Another simplistic way to state that a plan vote was made in "good faith" is to argue that it was not made in "bad faith." Unfortunately, this leads to a similar problem in that the term "bad faith" is not defined in the Bankruptcy Code.

In a frequently cited case involving trading claims, *In re Allegheny International, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990), the court disqualified votes by Japonica Partners, an investment firm, and confirmed the debtor's plan. Japonica was not a prepetition creditor of the debtor, but after approval of the debtor's disclosure statement and after balloting had commenced, Japonica purchased enough claims in two classes to wield a blocking position and to qualify Japonica as a party who could file a competing plan; however, those two classes were diametrically opposed to each other in litigation filed by the Creditor's Committee against the secured lenders. Japonica presented its own competing plan, which provided that Japonica would acquire control of the debtor. Neither the debtor's nor Japonica's plan received sufficient affirmative votes for confirmation.

Japonica's purpose was to gain control of the debtor, which the court found to be bad faith. The critical fact that resulted in the court's disqualification of Japonica's votes was that Japonica was a voluntary creditor who purchased claims to give it unique control over the debtor and the bankruptcy process. Another indication of Japonica's bad faith was the timing of its purchase and the amounts it paid for the claims. As Japonica approached the attainment of a blocking position, the amount it paid for the claims it purchased increased and then decreased after the critical percentage was reached. Japonica purchased almost exactly the amount it required to block the debtor's plan.

The court concluded that the facts and circumstances surrounding Japonica's purchase of claims—Japonica's intent to take over the debtor, the timing of the purchases, the amount paid for the claims, Japonica was an "outsider" prior to its purchase of claims, and Japonica's use of its veto power to improve its position—established that Japonica's votes were acquired and cast in bad faith and would be disqualified.

Other cases have been more relaxed in finding bad faith in the conduct of plan voting. In contrast to the holding in *Allegheny International* is the holding of *In re Marin Town Center*, 142 B.R. 374 (N.D. Cal. 1992). In the *Marin Town Center* case, as in *Allegheny International*, an "outsider" purchased an undersecured creditor's claim for the purpose of blocking confirmation in hopes that the creditor could acquire the debtor's main asset. The fair market value of the asset approximately equaled the amount paid for the claim. The court held that merely exercising a blocking position does not constitute bad faith. The creditor must be exercising the blocking position "for the ulterior purpose of securing some advantage to which the creditor would not otherwise have been entitled." *Id.* at 378. "Section 1126(e) does not require a creditor to have an interest in seeing the debtor reorganize." *Id.* at 379.

Questions of good faith and bad faith are factual in nature, and sometimes the line between the two is not always clear. The distressed debt investor is cautioned to consult with experienced bankruptcy counsel prior to developing and effectuating a claim trading strategy.

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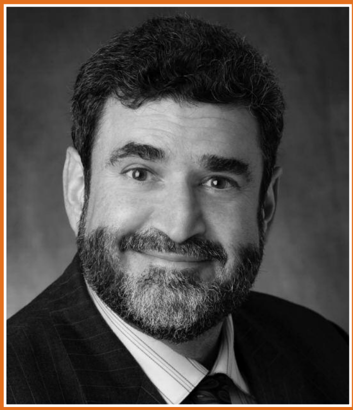
Get to Know **Will Kohn...**



Who: William I. Kohn is Chair of the firm's Business Reorganization Practice Group. He has more than 30 years of experience in the reorganization practice, with a focus on representing corporate debtors, banks, unregulated lenders and secured parties in Chapter 11 proceedings, out-of-court workouts, debt restructuring and DIP financing. He also counsels national manufacturers and distributors with respect to restructuring debt and supplier relationships.

Will takes an active leadership role within the legal community. He is the current President-Elect and former Treasurer of the American Board of Certification, the only ABA- and State Bar-recognized authority for certifying attorneys in Business and Consumer Bankruptcy Practice nationally. He also is a former Adjunct Professor of Bankruptcy and Banking Law at the University of Notre Dame College of Law.

What Will wants you to know about the Business Reorganization industry: The Market is sending many mixed signals—is the recession here, is it next quarter, or has it slipped by without a large BANG? The FED has aggressively lowered rates and added liquidity to the financial sector, and on a given day, the stock market would make a convincing exhibit that the worst has passed. BUT consumer confidence remains low, unemployment remains a constant concern and there are several industries truly hurting.

Almost all aspects of automotive are suffering, impacting the related industries of plastics, rubber and the various services dependent on automotive. Increasing petroleum costs will only exacerbate the issues. Lending continues to toughen its standards, preventing any significant recovery in real estate. As retail weakens, more pressure will emerge on major real estate projects and shopping chains. When all these downward effects start being felt in the credit card sector, a full-blown recession will be in place. For those companies that have prepared for this down cycle by reducing debt and carefully reviewing product lines, the opportunities to build market share will never be more promising.

When Will is not practicing law: You may find him reading either history or mysteries or enjoying driving trips to historic sites. A game of Monopoly or Risk is also a great pastime of Will's. Will resides in Pepper Pike with his wife, Karen. They have three children, Shira, Kinneret and Asher.

Acquiring a Financially Troubled Company in Financially Troubled Times: A "How To" and a "Why Do"

In today's near-recession landscape, finding financially troubled companies doesn't take binoculars or a crystal ball. Many manufacturers of consumer durables, including suppliers to the automotive industry, construction (direct and indirect, i.e., appliances) and major service providers from international banks, insurance companies and investment houses are all in play as cash flows become trickles, supplier *and* customer bases shrink and there are no sources of succor on the horizon.

Today's market may create a terrible time to sell—but it may be one of the best times to buy. As a purchaser, you will not get the best price on an umbrella in a rainstorm, but you may get a bargain if you buy while the sun is shining.

Why Seek a Transaction

Opportunistic owners can view the current unsettled market as the perfect chance to build market share or enter a new market at the potentially lowest cost and strategically place themselves to greatly capitalize on their bargain acquisitions as the economic cycle turns.

So why should a company be poised to ride out the current downturn look to acquire?

1. Strategic assets may not be available for sale in the market in better times.
2. Strategic assets will certainly not be available at current pricing if investment money becomes more available, the appetite for commercial lending returns and, in such an improved environment, additional competitors are drawn to the same targets.

Special Considerations in Acquiring a Distressed Business

The acquisition of a distressed business has its own unique difficulties: a prospective suitor needs to conduct careful due diligence to ascertain the motivation of the seller (lack of liquidity or is the product about to become obsolete?), key elements of the business (sole source supplier about to be liquidated or major customer just developed a new replacement technology?) or whether another target is the real dominant player in the sector. Also key for the due diligence effort is to confirm the sources creating the financial difficulty of the target: Are they incurable such as those suggested above, or is it a matter that a different operating model under new leadership (which the potential acquiring company is confident it can provide) will cure?

As part of the due diligence process, understanding who is determining the urgency of a transaction can be quite telling.

Moving to a Deal

The move to acquire a financially troubled business requires several deliberate but prompt actions:

Assemble an Acquisition Team. The purchasing company will want to team with professionals who will work seamlessly with company representatives and have transactional experience with the special issues arising in a situation where the target may be (or just as risky—is determined later to be) an insolvent company. The Team will, therefore, be comprised of the company's experienced management to evaluate the quality of the target's management and operational systems and to determine "real" not "logical" cost savings from potential "synergies." The legal aspect of the Team must include seasoned transactional attorneys who can bring focus on the material aspects of a time-sensitive due diligence effort and experienced creditors' and debtors' rights counsel to help guide the parties to a prompt closing.

A company cannot transfer its property free and clear of liens unless the secured creditor agrees to release its liens upon receiving a discounted payment. Similarly, shareholders cannot receive payment for transferring their interests if general creditors are going to remain unpaid. These principals require that most acquisitions of financially troubled companies are "asset purchases" rather than a "stock purchase" transaction.

As part of the due diligence process, understanding who is determining the urgency of a transaction can be quite telling. If the major working capital lender is forcing the sale because of a default in the target's working capital line, the company may be under threat of closure and the seller's anticipated sale price will be greatly discounted to avoid the threat of liquidation.

The Acquisition Team should, early in the process, structure a "liquidation analysis" of the target company. This analysis reasonably estimates a closed company's value with regard to the sale of its facilities (discounted by holding costs such as taxes, security, insurance and sales commission), the orderly liquidation value in place of the equipment (discounted by auction costs), the value of inventory (little for raw and work in progress) and receivable collections (less discounting for warranty loss and perhaps other contractual rights such as advertising allowances).

Practical issues that must also be considered are the existence of personal guarantees of any of the target's principals for any segment of the company's indebtedness, the nature of pending suits and the status of the company's tax liabilities (which may, depending on the nature of the unpaid tax, be a lien on some or all of the company's assets or create personal liabilities for some of the company's officers).

Other aspects impacting price consideration, and even whether or not to buy, include analysis of the target's standing within its market and its reputation with its customers. Interviews with key customers are important as is understanding existing and likely competitors and their financial strength.

For most companies, their most valuable assets are their employees, including knowledgeable and loyal middle management and an experienced line crew who know the product and how to produce efficiently. Most employee claims are protected under both state and federal law, and any plan premised on significant labor savings, particularly wage cuts, must realistically consider the effect on productivity and turnover. Maintaining key personnel may also become a condition to a final transaction and must be considered as an economic item in the purchase negotiations.

Legal due diligence is particularly critical in a financially troubled situation. Warranties given by the selling company as part of the transaction documents will turn out, in many cases, to not be enforceable, so any underlying risk must be reflected in a discounted offering price by the buying company.

Legal review of non-competition agreements of key employees, the status of existing liens and the property subject to liens, the risk of subsequent liens, such as mechanics' liens that become fixed later but date back to a prior time, are all critical issues to be reviewed. Key supplier contracts, their duration and assignability and alternate supply sources are part of this critical review as are the customer relationships, whether sole source, price-sensitivity, and the history of warranty claims.

Many times a condition to close is the requirement for releases from the general creditors in exchange for some partial payment (remember the liquidation analysis) plus, perhaps, an agreement to continue to buy from existing suppliers as long as pricing remains competitive. Most transactions will have 80% of the general debt of the target held by less than 20% of the number of creditors of the target, allowing the buyer to settle with a relatively small number of creditors to allow the transaction to close and perhaps assume the balance of known payables, with a credit against the sale price.

Another solution to the unpaid creditor issue is to consider a "Section 363" bankruptcy sale for larger transactions. The benefit is that the ultimate sale will be approved by a federal court and binding on all creditors, assuring good title to the purchaser. However, the moderate delay (average 45 to 90 days), the interim operating costs, and the costs of a bankruptcy filing make this tool more practical for larger transactions.

A sale in bankruptcy requires an auction-like process, which may let competitive bidders emerge, and there is an entire strategy involving "stalking-horse bidding" and alternative strategies of reorganization with outside funding that are beyond the scope of this article.

With all this complexity and risk, why engage in seeking to acquire the business of a financially troubled company? As in any market, the pricing of the transaction must justify the effort. For those companies that grow strategically in a down market, the profits to be realized as the business cycle turns will more than amply reward the risk takers.

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Delaware Supreme Court Says—Directors Cannot be Sued Directly by Creditors for Breaches of Fiduciary Duty Claims

Creditors of Delaware corporations that are insolvent have no right, as a matter of law, to assert *direct* claims for breach of fiduciary duties against the corporation's directors. In a recent decision of the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 Del. LEXIS 227 (Del. May 18, 2007), the Delaware Supreme Court extinguished any ongoing questions previously raised by the judiciary in Delaware that any individual creditor of a Delaware corporation has the right to assert a direct claim for breach of fiduciary duty against the directors of an insolvent corporation.

[A]s long as the directors comply with the business judgment rule and observe legal obligations to a solvent corporation's creditors in good faith, the directors are entitled as fiduciaries to pursue the course of action that they believe is best for the corporation and its shareholders.

The complaint filed by North American Catholic Educational Programming Foundation, Inc. ("North American"), a creditor and not a shareholder of Clearwire Holdings, Inc. ("Clearwire") alleged that the directors of Clearwire (i) fraudulently induced North American to enter into and perform a contract with Clearwire; (ii) breached their fiduciary duties to the creditors of Clearwire; and (iii) tortuously interfered with the creditor's business opportunities. The complaint alleged direct, rather than derivative, fiduciary duty claims against the directors of Clearwire resulting from the directors' ability to control Clearwire and use this power in derogation of their fiduciary duties to North American by not preserving the assets of Clearwire for its benefit, when it became apparent that Clearwire would not be able to continue as a going concern and would need to be liquidated.

Insolvency under Delaware law is determined using the "Balance Sheet" test or the "Equity" test. The Court in *North American*, applying the "Balance Sheet" test, which provides as follows: "(1) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face hereof, or (2) an inability to meet maturing obligations as they fall due in the ordinary course of business," found that Clearwire operated in the zone of insolvency. The Court has long since held that in insolvency situations creditors may protect their interest by bringing derivative claims on behalf of the insolvent corporation or any other direct non-fiduciary claim it may have by law or contract. North American had asked the Delaware Supreme Court to recognize a new *direct* right for individual creditors to challenge directors' exercise of business judgment as breaches of the fiduciary duties owed to them when a corporation is insolvent or in the zone of insolvency.

It has been well established under Delaware law that the law limits creditors' ability to assert fiduciary claims against directors of solvent corporations because creditors are protected by their contractual agreements and a well-established body of fraudulent transfer law. That said, as long as the directors comply with the business judgment rule and observe legal obligations to a solvent corporation's creditors in good faith, the directors are entitled as fiduciaries to pursue the course of action that they believe is best for the corporation and its shareholders. The Delaware Supreme Court in *North American* used the same reasoning and found that the creditors in this case have existing protections, including protections negotiated by contract, implied covenant of good faith and fair dealing and fraudulent conveyance laws, and the need for added protection through direct claims for breach of fiduciary duties are unnecessary and are outweighed by the need to protect directors and their ability to negotiate in good faith with creditors. Thus, the Court's ruling was necessary, in its view, to encourage capable persons to serve as directors of corporations by providing them with freedom to make risky, good faith business decisions without fear of personal liability.

However, in an insolvency situation, caution must be maintained by directors as the focus of the directors does shift from the primary focus on shareholders to maximizing payment to creditors. Directors of insolvent corporations do have fiduciary duties to the corporation's creditors and such fiduciary duties give creditors standing to pursue derivative actions for the benefit of all creditors.

While the Delaware Supreme Court has taken this leap with its holding in *North American*, the Court has still left many questions unanswered. Notably, the distinction between insolvency and the zone of insolvency and the exact differences between the two as related to creditors' ability to gain standing to maintain a derivative action. When a corporation is solvent, director's fiduciary duties are enforced by shareholders, and the shareholders have the ability to bring derivative actions on behalf of the corporation. As noted by the Court in *North American*, when a corporation is insolvent, the creditors take the place of shareholders as the residual beneficiaries of any value that may exist. Upon insolvency, the creditors have an interest in any increase or decrease in value of the corporation, and a creditor may have standing to assert a derivative claim based on fiduciary duty against an insolvent corporation. These claims are derivative as they involve an injury to the corporation as an entity, and any harm to the creditors is purely derivative of the direct financial harm to the corporation itself. But what must be remembered is the fact that the corporation has become insolvent does not turn such claims into direct claims against the directors, but merely provides creditors with standing to assert those claims in a derivative action.

Creditors still have the ability to seek recourse against directors of insolvent corporations through derivative actions if no direct non-fiduciary action may be maintained under breach of contract or fraudulent transfer law theories.

While the holding of the Delaware Supreme Court in *North American* may to some be characterized as "groundbreaking," we must not lose sight of the existing law that remains unchanged in Delaware, which includes the protections provided to directors under the business judgment rule that absolve directors and officers of personal liability for good faith business decisions. While the focus of directors in an insolvency situation does switch to the creditors, based on the decision in *North American*, this does not open the directors up to personal liability for direct claims by individual creditors. Creditors still have the ability to seek recourse against directors of insolvent corporations through derivative actions if no direct non-fiduciary action may be maintained under breach of contract or fraudulent transfer law theories. The Court in *North American* reasoned that allowing maintenance of direct claims by individual creditors would create uncertainty for directors because the duty to creditors would conflict with the directors' duties to shareholders to maximize value. In short, the Court stated in reaching its holding, "directors of solvent corporations operating in the zone of insolvency must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation."

For more information on this topic, please contact Bradford J. Sandler at bsandler@bfca.com or (302) 442-7010.

Representative Transactions

Some of our recent client engagements include:

- Represented Johnson Rubber Company, an engineered polymer producer that generated $60 million in sales, in the company's Chapter 11 Bankruptcy Proceeding and subsequent liquidation.
- Represented Blackhawk Automotive Plastics, Inc., a Tier 1 plastic molds automotive supplier that generated sales in excess of $130 million, in the company's Chapter 11 Bankruptcy and successfully negotiated sale of the company.
- Represented a multibillion-dollar distressed hedge fund, as senior lender and mortgagee of a produce terminal in state court receivership, in negotiating a cash settlement of the fund's disputed senior liens and closing an auction sale of ultra-specialized industrial real estate.
- Representing a 100-plus-year-old decorative glass manufacturer in comprehensive restructuring of debt and capital structures, including negotiations with PBGC concerning Union employees' PBGC guaranteed pension plans.
- Representing an approximately $200 million revenue scrap metal trading and refining group of companies in restructuring, including restructuring in excess of $35 million secured debt.
- Serving as special conflict counsel to the Official Committee of Unsecured Creditors in the Chapter 11 bankruptcies of Dan River, Inc. (and its subsidiaries), a leading manufacturer and marketer of textile products for the home fashions and apparel fabrics market with over 3,500 employees throughout the United States and Canada.
- Represented a landlord in the Sirva bankruptcy proceedings in New York by objecting to the Debtors' plan of reorganization and participating in 5 days of trial so that the landlord will now receive a significant distribution.
- Represented seven nursing home facility group to stabilize operations and conclude $55 million sale.
- Represented official Creditors' Committee of G&C Foundry maximizing return to creditors after successful sale.
- Represented a national shopping center developer in construction of mall, which required maintenance of zoological park compliance with state and federal regulation.

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